

**Internal Revenue Service
Appeals**

Department of the Treasury

Address any reply to:

Release Number: **200842057**
Release Date: 10/17/08
Date: July 23, 2008
UIL Code: 501.33-00

Employer Identification Number:

Form Number:

Person to Contact:

Contact Telephone Number:

Fax Number:

**Last Day to File a Petition with the United
States Tax Court**

A = Taxpayer Name
B = For-Profit Corporation
C = Beginning Year for Filing Forms 1120
D = Telephone Number of Local Taxpayer
Advocate Office
E = Address of Local Taxpayer Advocate
Office

Certified Mail

Dear

This is our final adverse determination with respect to your exempt status under section 501(a) of the Internal Revenue Code ("Code"). Recognition of your exemption under Code section 501(c)(3) is revoked beginning July 1,

If you decide to contest this determination under the declaratory judgment provisions of Code section 7428, a petition to the United States Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia must be filed within 90 days from the date this determination was mailed to you. Contact the Clerk of the appropriate court for rules for filing petitions for declaratory judgment. To secure a petition from the United States Tax Court, write to the United States Tax Court, 400 Second Street, N.W., Washington, D.C. 20217.

Our adverse determination was made because **A** is not operated exclusively for exempt purposes. Under Treasury Reg. § 1.501(c)(3)-1(d)(1)(ii), an organization is not operated exclusively for exempt purposes unless it serves a public rather than a private interest. In your lease agreement with **B**, you ceded effective control over your operations to a for-profit corporation, impermissibly serving private interests.

Contributions to your organization are not deductible under Code section 170.

You are required to file Federal income tax returns on form 1120 for any years, which are still open under the statute of limitations. Based on the information you furnished, it appears that returns should be filed beginning with **C**. You should file any returns due for these years or later years


with the Internal Revenue Service Center, Ogden, UT 84201-0012 (as applicable for 1120). Processing of income tax returns will not be delayed because you have filed a petition for a declaratory judgment under Code section 7428.

If you have questions about this letter, you may write to or call the contact person whose name, telephone number, and IRS address are shown on the first page of this letter. If you write, please include your telephone number, the best time for us to call you if we need more information, and a copy of this letter to help us identify your account. Keep the original letter for your records. If you prefer to call and the telephone number is outside your local calling area, there will be a long distance charge to you.

The contact person identified on the front of this letter can access your tax information and help you get answers. You also have the right to contact the office of the Taxpayer Advocate. You can call 1-877-777-4778 and ask for Taxpayer Advocate assistance, or you can contact the nearest Taxpayer Advocate office by calling **D** or writing to Local Taxpayer Advocate, **E**. Taxpayer Advocate assistance is not a substitute for established IRS procedures such as the formal appeals process. The Taxpayer Advocate is not able to reverse legally correct tax determinations, nor extend the time fixed by law that you have to file a petition in the U.S. Tax Court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling.

We will notify the appropriate State officials of this action, as required by IRC section 6104(c). You should contact your state officials if you have any questions about how this determination may affect your state responsibilities and requirements.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Tim Fisher" with a stylized flourish at the end.

Charles F. Fisher
Appeals Team Manager

LEGEND

ORG = Organization name XX = Date Address = address City =
city XYZ = State ESQ, ESQ-1, ESQ-2, ESQ-3 = 1st, 2nd & 3rd ESQ
ADM-1 = 1st administrator President = president President-2 = 2nd
president CO-1, CO-2, CO-3, CO-4, CO-5, CO-6, CO-7, CO-8 = 1st, 2nd,
3rd, 4th, 5th, 6th, 7th & 8th Companies

FACTS

Background History

Early in 19XX, a group of concerned City residents formed the CO-1, for building a ORG with community raised funds and matching government grants. On March 25, 19XX, groundbreaking ceremonies took place, and on August 23, 19XX, ORG (ORG) was officially dedicated. The -bed health care facility admitted its first patient on September 3, 19XX. By March of 19XX, the ORG opened the West Wing, expanding the bed capacity to of which 10 beds were designated ICU beds. With the closing of the East Wing in 19XX, the bed capacity changed to its present day . Six of these beds are ICU beds updated with the latest monitoring equipment.

Organizational Structure Prior to the CO-1 Lease Agreement

ORG was first formed as an Association under the name of CO-1. The Association terminated on August 4, 19XX, when it incorporated as a not for profit and changed to its current name.

ORG's corporate powers vested with its Board of Trustees. The board's responsibilities included but were not limited to:

- a) The employment of personnel
- b) Pay out of all necessary expenses
- c) Provide the necessary facilities for the conduct of health care
- d) Elect the officers of the corporation, President, Two Vice-Presidents, Secretary, Treasurer and ORG Administrator
- e) Make appointments to the Medical Staff
- f) Direct the manner in which routine and special activities, are carried out and designed to further the objectives of the corporation. (Exhibit 1)

There were two classes of membership: Honorary which was bestow on members that would add honor to the ORG and Sustaining which were those who sustained the ORG's objective, contributed financial support and had the right to be elected to the Board of Trustees.

Sustaining category consisted of the following:

- a) Governors - required to contribute \$ and became a member for life.
- b) Founders - who contributed \$ retain membership for life, and
- c) Regular members - persons that pay annual dues of \$.

The board elected the corporate officers who ran the business of the ORG through various committees. The following principal committees and its responsibilities were:

Executive Committee- Represented the Board of Trustees between meetings of the Board Joint Conference Committee – consist of an equal number of members of the corporation and the attending Medical Staff. Act as a liaison group between the Board of Trustees, the administration and the Medical Staff. Finance Committee- Responsible for the preparation of the budget

The other committees were Building and Grounds, Gifts and Endowments, Public Relations, Legal, Special (specific purpose). (Exhibit 1)

The Board of Trustees organized the physicians and dentists, granted practice privileges in the ORG, had sole power to set up, and approved the bylaws, which governed them. Dismissal or failure to renew their practice privileges could appeal to the Board of Trustees. (Exhibit 1)

The daily management of the ORG vested with the Administrator subject to the control and direction of the Board of Trustees. According to the revised and adopted By-Laws dated March 24, 19XX, the duties of the Administrator included but were not limited to: "...carrying out all policies established by the Board of Trustees...; perfect and submit for approval a plan of organization of the personnel...; prepare an annual budget showing the expected receipts and expenditures as required by the Executive Committee...; select, employ, control and discharge all employees...; see that all physical properties are kept in a good state of repair and operating condition...; supervise all business affairs and to ensure that all money is collected and expended to the best possible advantage...; work with the medical staff and will all those concerned with the rendering of professional service ...;submit regularly to the Board of Trustees or its authorized committees...reports showing the professional service and financial activities of the ORG and...; attend all meetings of the Board of Trustees and its Committees...; perform any other duty that may be necessary...;serve as the liaison officer and channel of communications for all official communications between the Board of Trustees or any of its committees and the Medical Staff." (Exhibit 1)

The Board of Trustees 'duties remained constant until July 15, 19XX, when the board relinquished control of the ORG facilities and its operation to CO-1 a subsidiary of CO-2 a City, XYZ based for profit corporation that specializes in acute health care management.

501(c)(3) Status

ORG first applied and secured a tentative ruling on March 3, 19XX, as a charitable organization under the name of CO-1. The exempt purpose listed was to raise funds in order to match the CO-3 government grants used for the construction of the ORG.

On October 9, 19XX, ORG filed Form 1023, Exemption Application listing their purpose as "Care for the sick, to carry on scientific research related to the sick and training

institution for faculty". The Service issued them a private ruling on December 28, 19XX, stating that another tentative ruling was not required but that they should apply again after the ORG had been operative for a full year. The Service issue a definitive ruling on March 25, 19XX, granting exemption from federal income taxes under Section 501(c)(3) of the Code. The Service's administrative file shows that ORG's Administrator ADM-1 filed Form 4553, Notification Concerning Foundation Status on July 27, 19XX, and again on December 13, 19XX, confirming they were a ORG under Section 170(b)(1)(A)(iii).(Exhibit 2)

Organizational structure after entering into a lease with CO-1. (CO-1)

On July 15th, 19XX, ORG's Board of Trustees entered into a 15-year lease agreement with CO-1. To separate and differentiate the two corporations for the benefit of the public and when doing business, ORG used the name of ORG's ORG Board Association, Inc. .

The agreement limited and changed the activities, duties and role of the trustees. When it deals with the operations of the ORG, they can only advise CO-1. When it deals with the ORG and medical office buildings, their role is one of a property owner.

The 20XX Bylaws lowered the annual membership dues to \$ and life membership to a member who donates \$. The annual meeting of the membership is held the first week of December and is use to elect 14 members to serve as trustees. The Board of Trustees is responsible for the business of the ORG Association. Any new member or existing member beginning a new term is disqualified from membership on this board if they are on CO-1's advisory board¹.

ORG's web site provides a listing of their recent accomplishments/ activities, which are:

Emergency Room Renovation Project- (Major Contributor) ORG's ORG Medical Complex – Entirely funded capital improvements. New TVs for Patient Rooms – Co-funded with Auxiliary. Scholarship Program – on going Employee support and High School Seniors. Patient Transport Van – Co funded with Auxiliary Board Member continuing Education – Participated CO-1.

The Board of Trustees minutes verified the statements noted above. The Board members continuing education encompassed an annual tour of the ORG facilities, annual board membership dinner that is open to Medical doctors.

Section 501(c)(3) Status after the lease agreement with CO-1

Since entering into a lease with CO-1, ORG has secured three legal opinions. On a letter dated April 21, 19XX, ORG was told by ESQ, Esq. of the firm of CO-4, in City, XYZ that based on the terms of the lease agreement and the requirements of Section 501(c)(3) it no longer qualified as a "ORG". The letter also tells them of the requirement to inform the

¹ Board of Trustee Bylaws 20XX Article II Section 1.5f

Service of any material change in its operation and that ORG could prepare and file a request for a ruling on their exempt status.

ESQ-2, Esq. of the firm CO-5 in City, XYZ wrote on May 26, 19XX to ORG and indicated that their tax-exempt status may be in jeopardy if they build a new surgical wing for CO-1's use without an increase in the base rent. It told ORG to consider requesting a private letter ruling before going further with such an arrangement.

The last legal opinion secured is from the legal firm of CO-6 of City, XYZ, dated August 29, 20XX. The firm stated that the acquisition of the medical office complex located at Address further ORG's tax exempt purpose since it help provide health care in its geographic area..

ORG did not secured a legal opinion about its decision to purchase the Address building also known as ORG's ORG Medical Complex for \$, from past board member, President, President of CO-7 and giving the building to CO-1 without remuneration for seven years.

ORG never requested a private letter ruling or notified the Service of its change of operations or sources of funding. ORG's filed Form(s) 990 Return of Organization Exempt from Income Tax for the years ending June 30, 19XX through 20XX indicates to the Service that the organization is not a private foundation because it's a ORG or a cooperative ORG service organization under Section 170(b)(1)(A)(iii) of the Internal Revenue Code. On September 3, 19XX, EPEO Customer Service reissued at ORG's request a determination letter indicating that they were exempt from Federal Income Tax under section 501(c)(3) of the Internal Revenue Code. The letter from the Service states, "This classification is based on the assumption that your organization's operations would continue as stated in the application. If your organization sources of support, or its character, method of operations, or purposes have changed, please let us know so we can consider the effect of the change on the exempt status and foundation status of your organization." ORG's Board of Trustees opted again to disregard the notification requirements as stated in the Service's letter.

Lease Agreements regarding ORG facilities and medical office buildings

On August 1, 19XX, a month after the signing of the Lease Agreement, ORG complied with the CO-1's lease terms Article 30(b) and provided to CO-1 a legal opinion from ESQ-3 that attest to the facts as follows "... Board of Trustees of ORG's ORG has the lawful authority to enter into the Lease and, further, that said Lease would be binding upon the Lessor and its successors." On the same date ORG signed a "Closing Memorandum" that described the "Actions taken prior to Closing" and "Actions taken at Closing" including a "Bill of Sale" which listed the assignment for all personal property both tangible and intangible, and all listed contracts and leases.

The Bill of Sale documents states that "...Seller has sold, conveyed, transferred, assigned to, vested in, and by these presents does sell, convey, transfer, assign to, and vest in, Buyer, its successors and assigns forever, all of Seller's rights, title and interest, legal or equitable, in and to all of the assets described in Schedule A..." Schedule A list under section (i)All

cash accounts and bank accounts, ...construction funds; accounts receivable; inventory; contracts; leases (both where Seller is Lessor and Lessee); fixtures and equipment...(iii) All right, title and interest in and to the name "ORG's ORG, Inc." and variants thereof in CO-1, XYZ; (iv) All prepaid taxes and expenses attributable to the business or operations of the ORG." The documents were signed by the then ORG's Chairman – President of the Board of Trustees President-2.

The lease agreement called for the formation of ORG's Advisory Board whose By-laws gave voting control over any and all decisions to CO-1, and CO-1, CO-1 Inc. doing business as ORG's ORG. The board was made up of the board members elected by ORG's ORG Association, the Medical Chief of Staff, an CO-1 officer, and the ORG administrator an employee of CO-1.

Under the terms of the lease agreement, ORG agreed to relinquish control over all the assets and activities of the ORG in return for an annual rental fee of \$ and the assumption of all its outstanding liabilities, including the retirement of its existing bond debt of \$.² ORG was also promised million in capital renovations and equipment for the first 3 years of the lease.

Pursuant to the terms of the lease agreement, CO-1 was to operate ORG's ORG and its related activities with the exclusive right to use and control the entire ORG operations, including, but not limited to, administration, services, finances and non-medical staffing, equipment, inventory, furnishings, supplies, renovation, and any additions or expansions of the ORG facilities made by CO-1. CO-1 was required to operate an Emergency Room staffed twenty-four hours per day, seven days per week at all time during the term of the lease. CO-1 was also required to provide treatment for all emergency patients and accept all non-elective patients who were residents of its service area, and who were determined to be indigent pursuant to the criteria established under XYZ law. Any indigent patient admitted to the ORG was to be provided the full spectrum of ORG services without regard to the patient's ability to pay.

At the expiration of the lease, ORG was given an option to purchase any assets and equipment placed into service at the ORG by CO-1.³

² The original amount of bond debt was \$ million, evidenced by a Trust Indenture for ORG's ORG dated December 1, 19XX. According to the examination, the \$ in existing bond debt was paid off by CO-1 prior to CO-1 and ORG entering into the lease agreement.

³ Article 20.1 of the lease agreement provides:

Current Assets and Current Liabilities. As set out in Article 7 of this Lease Agreement, as of the Lease Commencement Date, Lessee ("CO-1") is assuming all current assets (excluding the CO-8) and assuming all current liabilities and other long-term debt of Lessor ("ORG"). The Lessor's independent auditor shall prepare a balance sheet as of said date that shall be attached to this Lease Agreement as Exhibit D. Upon the expiration of the Lease Term, Lessee shall deliver to Lessor current assets at least equivalent in value to the net difference (current ratio) in current liabilities as shown on Exhibit D. **Upon the**

On December 18, 19XX, ORG and CO-1 made the following amendments to the lease agreement. Both parties agreed to extend the lease term for another 10 years without any increase in the rental fees. CO-1 also agreed to spend \$ million during the first ten years of the lease ending July 14, 20XX, and another \$ million during the last ten year ending July 14, 20XX, for ORG improvements and equipment over the extended lease term.

ORG received two legal opinions concerning its lease arrangement with CO-1. CO-4 legal opinion advises ORG that its tax-exempt status may be in jeopardy since it may no longer be operating for a charitable purpose but rather a commercial one by relinquishing complete control of the operations of the ORG to a for profit entity and receiving only rental income as its primary activity. The part of CO-5 legal opinion dealing with CO-1's lease agreement advises ORG that it does not adversely affect its tax-exempt status since ORG satisfies the "community benefit standard" set out in Rev. Rul. 69-545, 1969-2 CB 117 and the lease furthers ORG's tax-exempt purpose.

ORG purchased a Medical Complex Building located at address on April 11, 19XX for \$. CO-1 had free usage of the Medical Complex located at address from April 11, 19XX, till September 28, 19XX. ORG then entered into a written lease for a term of five years at the base monthly rental of \$ plus applicable sales tax there on. The annual rent was adjusted by the rate of inflation as determined by the Consumer Price Index. Section sixteen (16) of the lease gave CO-1 the right to sublease the premises to licensed Practitioners only for the purpose of the practice of healing Arts. All sublease had to be approved by ORG's Executive Committee. On August 30, 20XX, this lease was renewed for another five years ending on August 31, 20XX for the agreed total rental of \$ at the rate of : First year \$; Second year \$; Third year and thereafter \$ plus the applicable current sales tax applicable (7.5%).

ORG invested a substantial sum of the money it received under the lease agreement to expand the facilities of the ORG by constructing a new surgical wing. The new surgical wing was constructed, however, primarily for CO-1's benefit and use. In 20XX, ORG purchased an adjacent medical office building from four doctors for \$ million, which it then immediately leased to CO-1 for an annual rent of \$, who in turn subleased it back to the same four doctors. The purchase contract agreement expressly provided that in order for the purchase to be consummated all three parties were required to enter into the lease and sublease agreements simultaneously. The sale, lease and sublease transactions were

expiration of the Lease Term, Lessor shall have an option to purchase any assets in excess of those delivered above in compliance with this paragraph.

Article 20.3 of the lease agreement provides:

Purchase of Equipment. Upon expiration of the Lease Term, Lessor shall have the option, but shall not be obligated, to purchase all equipment owned by Lessee and place in service at the ORG at Lessee's current book value or fair market value whichever is less. Further, Lessor may at its option lease Lessee' Computer Software at its then market lease price .

contingent on settlement of ongoing legal suits regarding medical practice restrictions, between CO-1 and the four doctors/owners of the medical office building. ORG Board of Trustees minutes report that the purchase of the building was a prudent investment, considering that it would have lost the money in the stock market if it had not purchased the building.

ORG also received a legal opinion, dated August 29, 20XX, from the law office of CO-6, P.A., regarding the purchase of the building. The opinion advises ORG that although the purchase price of the medical office building exceeds a fair market appraisal, the acquisition would not jeopardize its tax-exempt status because: (1) the purpose of the acquisition is to further ORG's tax-exempt purpose to provide healthcare in its geographic area; (2) the fact that the office building may not be able to be replaced due to a building moratorium; and (3) an income valuation methodology supports the acquisition of the building.

The lease agreement does not contain a termination clause allowing ORG's the right to terminate the agreement if the terms of the agreement or CO-1's operation of the ORG would jeopardize its exemption under section 501(c)(3) ORG. Copies of Exhibits and schedules identified in or associated with the Master Lease Agreement dated July 1, 19XX were requested from ORG and CO-1:

Exhibit A, which is a legal description of the ORG campus or the leased "Premises" as referred to in the lease agreement.

Exhibit B, which is a list of capital expenditures and equipment CO-1 agreed to provide with the \$.million in capital for the first 3 years of the lease.

Exhibit C, which is a form service contract used by the ORG to contract services for radiologists, pathologists, and anesthesiologists.

Exhibit D, which is a balance sheet of ORG's current assets and current liabilities that were to be assumed by CO-1, which was prepared by an independent auditor.

Exhibit E, which is the Governing By-Laws for the Advisory Board of Trustees.

Article 7, Transfer of Liability Schedule.

These documents, with the exception of Exhibits A and E, however, were not provided. ORG and CO-1 claims that the requested documents were either lost or that they were unable to locate them at the present time.

Capital Expenditures

Article 5 of the lease agreement sets forth the rental obligations of the lessee, CO-1, to the lessor, ORG's. Under the original terms of the lease agreement, which was entered on July 15, 19XX, CO-1 was required to pay and perform the following duties as part of its rental obligation to ORG's:

5.1 Annual basic rent of \$.

5.2 Additional Rent.

- (a) Assume and defease the ORG's outstanding bond obligations.
- (b) Pay all accounts payable reflected on the books of the ORG.
- (c) Pay all bank notes payable per balance sheet.
- (d) Assume all operating and capital leases of the ORG.
- (e) Assume all other current and non-current liability
- (f) Spend a minimum of \$ million for capital renovations and equipment during the first 12 months of the lease and an additional \$ million for capital renovations and equipment during the succeeding twenty-four (24) months of the Lease.
- (g) Pay all accumulated personal leave time to the ORG employees as of the commencement date of the lease.
- (h) Pay back over a nine month period the estimated Medicare Overpayment Liability not due to Medicare.
- (i) Pay the directors and officers of ORG's annual insurance premiums.

5.3 Other Obligations. Any obligation of Lessee which under the terms of this Lease is construed as a rental obligation.

The lease was amended on December 18, 19XX. The amendments made were as follows:

Lease Term: Ten (10) year extension of the lease term to July 14, 20XX.

New Capital Expenditures:

- (a) During the next ten (1) Lease Years (through July 14, 20XX) of the extended Lease Term, the Lessee shall expend a minimum of an additional \$ million for improvements and equipment to the

Premises.

- (b) During the final (10) Lease Years (through July 14, 20XX) of the extended Lease Term, Lessee shall expend a minimum of an additional \$ million for improvements and equipment to the Premises.
- (c) The expenditures of a total of \$ million over the life of the extended Lease Term as set out in paragraphs 2(a) and 2(b) above shall be over and above the current obligations of the Lessee under Article 12⁴ of the Lease to keep and maintain the Premises.

⁴ **Article 12** of the lease agreement contains the provisions for Care Of Premises, Alterations, Additions, Major Capital Improvements.

12.1 Care of Premises provides in part that Lessee, at Lessee's expense, shall keep and maintain the premises and improvements, in good order and repair, ordinary wear and tear, Lessor's casualty loss and other Lessor's insured loss excepted.

12.2 Alterations, Additions, and Capital Improvements provides in part that Lessee shall have the right to make alterations, additions and capital improvements to the Premises with any alternations, additions and capital improvements that exceed \$ being subject to the Lessor's reasonable approval.

Rental Increase: Commencing with the Lease Year beginning July 15, 20XX, the annual rent shall be the base rent of \$ plus an adjustment to the Consumer Price Index revised per year not to exceed 5%, using the June 1, 20XX average index as the basic standard index.

Definitions: All terms used in this 1st Amendment shall have the same meaning as contained in the Lease, except where specifically amended by this 1st Amendment.

Remaining Lease Terms: Except as specifically amended by this 1st Amendment, all other terms and conditions of the Lease shall remain in full force and effect as set out therein.

LAW

Revocation of ORG's Exempt Status under Section 501(c)(3)

Section 501(c)(3) of the Code requires that an organization be operated exclusively for charitable purposes in order to be exempt from federal income tax. An organization is not operated exclusively for charitable purposes unless it serves a public rather than a private interest and its net earnings do not inure to the benefit of any shareholder or individual. Treas. Reg. § 1.501(c)(3)-1.

The presence of a single substantial nonexempt purpose can destroy the exemption regardless of the number or importance of exempt purposes. *Better Bus. Bureau v. United States*, 326 U.S. 279, 283, 90 L. Ed. 67, 66 S. Ct. 112 (1945); *Am. Campaign Acad. v. Commissioner*, 92 T.C. 1053, 1065 (1989); see also *Old Dominion Box Co., Inc. v. United States*, 477 F.2d 340 (4th Cir. 1973), cert. denied, 413 US 910 (1973) ("operating for the benefit of private parties who are not members of a charitable class constitutes a substantial nonexempt purpose"). When an organization operates for the benefit of private interest, such as designated individuals, the creator or his family, or persons directly or indirectly controlled by such private interests, the organization by definition does not operate exclusively for exempt purposes. *Am. Campaign Acad. v. Commissioner*, supra at 1065-1066.

If an organization serves both a public interest and a private interest, however, an organization will be exempt only if the benefit conferred to the private interest is incidental, and not substantial, to the exempt purpose served. See GCM 39598 (Jan. 23, 1987); Rev. Rul. 69-545, 1969-2 CB 117; and Rev. Rul. 78-86, 1978-1 CB 151.

A private benefit is considered incidental only if it is incidental in both a qualitative and a quantitative sense. In order to be incidental in a qualitative sense, the benefit must be a necessary concomitant of the activity, which benefits the public at large, i.e., the activity can be accomplished only by benefiting certain private individuals and the benefits are indirect or unintentional. Compare Rev. Rul. 72-559, 1972-2 CB 247, (an organization is exempt which provides relief of the poor and distressed by providing training and salaries to recent law graduates who agreed to provide legal services to indigents) with Rev. Rul. 80-287, 1980-2 CB 185, (an organization is not exempt under section 501(c)(3) which provides assistance to persons in need of legal services by operating a lawyer referral service). To be incidental in a quantitative sense, the private benefit must not be substantial

after considering the overall public benefit conferred by the activity. In other words, the private benefit conferred by an activity or arrangement is balance only against the public benefit conferred by that activity or arrangement, not the overall good accomplished by the organization.

The promotion of health has long been recognized as a charitable purpose. See Restatement (Second) of Trusts, section 368, 372 (1959). The Service first recognized the promotion of health for the benefit of the community as a charitable purpose within the meaning of section 501(c)(3) in Rev. Rul. 69-545, 1969-2 CB 117.

In Rev. Rul. 69-545, 1969-2 CB 117, the Service compares two hospitals. The first hospital discussed is controlled by a board of trustees composed of independent civic leaders. In addition, the hospital maintains an open medical staff, with privileges available to all qualified physicians; it operates a full-time emergency room open to all regardless of ability to pay; it otherwise admits all patients able to pay (either themselves, or through third party payers such as private health insurance or government programs such as Medicare); and it uses its surplus funds to improve the quality of patient care, expand facilities, and advance its medical training, education, and research programs.⁵ In contrast, the second hospital is controlled by physicians who have a substantial economic interest in the hospital. This hospital restricts the number of physicians admitted to the medical staff, enters into favorable rental agreements with the individuals who control the hospital, and limits emergency room and hospital admission substantially to the patients of the physicians who control the hospital. Rev. Rul. 69-545 notes that in considering whether a nonprofit hospital is operated to serve a private benefit, the Service will weigh all the relevant facts and circumstances in each case, including the use and control of the hospital. The revenue ruling concludes that the first hospital continues to qualify as an organization described in section 501(c)(3) and the second hospital does not because it is operated for the private benefit of the physicians who control the hospital.

The Service has recognized that nonprofit hospitals may enter into certain arrangements with for profit entities to jointly operate a hospital without losing their tax-exempt status. Rev. Rul. 98-15, 1998-1 CB 718, compares two situations where an exempt hospital forms a joint venture with a for-profit entity and then contributes its hospital and all of its other operating assets to the joint venture, which then operates the hospital.

In Situation 1, the revenue ruling concludes that the exempt organization will continue to further charitable purposes when it participates in the joint venture. Favorable factors include the binding legal obligation of the joint venture to give charitable purposes priority over maximizing profits; the community make-up and structure of the board; the voting control held by the exempt organization's representatives on the board; the specifically enumerated powers of the board; and, that the terms and conditions of the management contract are reasonable.

In Situation 2, the revenue ruling concludes that the organization will fail the operational test when it participates in the joint venture because activities of the joint venture do not

⁵ Otherwise known as the "community benefit standard."

promote community health and will result in greater than incidental private benefit to the for-profit partner. Factors leading to this conclusion include: shared voting control with the for-profit partner; no binding obligation to serve the community which will not necessarily give priority to the health community over maximizing profits; and the management company, a subsidiary of the for-profit partner, is given broad discretion over activities and assets.

A section 501(c)(3) organization may enter into a management contract with a private party giving that private party authority to conduct activities on behalf of the organization, and direct the use of the organization's assets provided, however, that the organization retains ultimate authority over the assets and activities being managed, and the terms and conditions of the contract are reasonable. See *Broadway Theatre League of Lynchburg, Virginia, Inc. v. U.S.*, 293 F.Supp. 346 (W.D.Va. 1968). If a private party is allowed to control or to use the nonprofit organization's activities or assets for the benefit of the private party, and the benefit is not incidental to the accomplishment of exempt purposes, the organization will fail to be organized and operated exclusively for exempt purposes. See *Est. of Hawaii v. Commissioner*, 71 T.C. 1067 (1979).

The Service has also recognized that certain lease arrangements between nonprofit hospitals and private individuals are consistent with the pursuit of furthering a hospital's exempt purpose. Rev. Rul. 69-463, 1969-2 CB 131, describes the leasing by an exempt hospital of an adjacent office building to a hospital-based medical group. Pursuant to arms-length negotiations, the hospital leased the building to the medical group for use to provide medical services for its private patients. The hospital provided the group with nursing, secretarial, billing, collection, and recordkeeping services in consideration of a fixed percentage of the group's gross billings to patients. The group was obligated, under the contract, to provide diagnostic and therapeutic procedures, such as anesthesiology and radiology, to all hospital patients, and to operate the hospital's emergency room on a 24-hour basis. Based on the hospital's showing that the group's presence resulted in the hospital fulfilling its role as the health center of the community and otherwise contributed importantly to the hospital's operations, the Service held the group practice was substantially related to the carrying on of hospital functions, and therefore the leasing activity was not an unrelated trade or business under section 513.

In Rev. Rul. 73-313, 1973-2 CB 174, the Service specifically addressed the private benefit argument and held that an organization which used community funds to construct a medical complex intended to attract doctors to its medically underserved rural community was exempt because the personal benefits derived by the doctors did not detract from the public purpose of the organization nor lessen the public benefits flowing from its activities. The organization made the medical building and facilities available at a reasonable rent to attract a doctor who would provide medical services to the entire community.

Similarly, in GCM 37789 the Service concluded that the extent to which a hospital provided personal benefits to staff members by leasing land adjacent to it to members of its staff and providing the staff with the financing to build a medical center on the land did not "detract from the public benefit flowing from these activities" and did not constitute "the type of private interest prohibited by the regulations." The hospital in question was the

only non-profit general hospital in a rural community without any specialists in certain areas such as orthopedic surgery and gynecology. The financing provided by the hospital was at a reasonable rate of return. The lease of land was presented and considered in two contexts, first at a rental of \$1.00 per year, clearly below fair rental value, and second at fair rental value. The Service determined that the financing at a reasonable rate and the lease at fair rental value resulted in only incidental private benefit, but that a lease at below fair rental value resulted in more than incidental private benefit to the staff doctors.

Capital Expenditures

Section 109 of the Code provides that gross income does not include income (other than rent) derived by a Lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee.

Section 1.109-1(a) of the regulations provides that the section 109 exclusion applies only with respect to the income realized by the lessor upon the termination of the lease and has no application to income, if any, in the form of rent which may be derived by a lessor during the period of the lease and attributable to buildings erected or other improvements made by the lessee. It has no application to income which may be realized by the lessor upon the termination of the lease but not attributable to the value of such buildings or improvements. Neither does it apply to income derived by the lessor subsequent to the termination of the lease incident to the ownership of such buildings or improvements.

Accordingly, in order for this exclusion not to apply, the lessor and lessee must intend that some or all of the lessee's capital expenditures are rent, and this intent must be plainly disclosed. In *M.E. Blatt Co. v. United States*, 305 U.S. 267, 277 (1938), the Supreme Court stated that whether the value of such improvements constitutes rent depends upon the intentions of the parties, and that even when the improvements are required by the terms of the lease this value will not be deemed rent unless the intention that it shall be such is plainly disclosed. Such intent is to be derived not only from the terms of the lease but from the surrounding circumstances. *Cunningham v. Commissioner*, 28 T.C. 670, 680 (1957), *affd.* 258 F.2d 231 (9th Cir. 1958)

GOVERNMENT'S POSITION

Private Benefit.

Lease Agreement.

ORG initially entered into a 15 year lease agreement in which it relinquished control over the assets and operations of the ORG to CO-1 for an annual rental fee of \$ the assumption of its outstanding liabilities, and \$ million in capital improvements. The lease was later renegotiated and extended for an additional 10 years in which CO-1 would provide an additional \$ million in capital improvements, but with no increase in the annual rental fee. In analyzing whether the lease agreement is consistent with the pursuit of furthering ORG's

exempt purpose, we must determine whether the private benefits that CO-1 received under the lease were incidental, both in a qualitative and quantitative sense.

Control.

Under the terms of the agreement, CO-1 was given complete control over the assets and operations of the ORG. Although an advisory board of trustees was required to be established by ORG's ORG association under the terms of the lease,⁶ the examination determined that the advisory board had no authority or voting control over the manner in which CO-1 managed the operations of the ORG. Under the terms of the lease agreement, the revenues generated by the ORG were to go to CO-1 with only \$ going to ORG as annual rent. CO-1 thus had every incentive to operate the ORG in a way to maximize profits over the interests of the community.

Board minutes indicate that the community made several complaints against the ORG for unreasonably high fees and aggressive collection tactics. The examination revealed that the fees charged by CO-1 were in fact excessive compared to other non profit ORGs. The examination also revealed that many of the complaints made by the community and ORG's advisory board fell on CO-1's deaf ears and the fees were not lowered. The board of directors minutes noted ORG's advisory board's displeasure with CO-1's ORG administrator, yet they could not fire him even though he failed to attend meetings, allowed for the timely review of doctors contracts, subleases, hiring and firing of doctors, etc. As spelled out in the minutes and CO-1 verbalized in more than one occasion, ORG was only a landlord and was treated as such when it came to ORG operations and residents complaints by CO-1.

We believe that for a nonprofit organization to relinquish complete control over its affairs to a for profit organization that is also the principal recipient of most of its net earnings constitutes an impermissible benefit. Accordingly, the control conferred to CO-1 is a direct and substantial benefit that is not incidental in either a qualitative or a quantitative sense. ORG should have retained enough control over the manner in which CO-1 managed the ORG in order to adequately represent and protect the interests of the community.

Capital Expenditures / Rental Fees

Under the terms of the lease agreement, ORG's received a constant flat rental fee of \$, indexed to CPI, with an additional \$ million in capital improvements and expenditures CO-1 agreed to provide as part of its rental obligation. From 19XX through 19XX, ORG invested a total of \$ to construct an addition to the Emergency Room and provide \$ worth of equipment to the ORG. In 19XX, ORG invested \$ to renovate the ORG entrance, and expended an additional \$ for landscaping in 20XX. In the years under examination, ORG invested \$ million to construct a new surgical wing, and another \$ to renovate the lobby area for the benefit and use of CO-1. Although ORG invested a substantial sum of its own

⁶ The Governing By-laws for the advisory board, which is identified in the lease as Exhibit E, has allegedly been lost and cannot be found.

monies to improve the operations of the ORG, which was under CO-1's control, ORG's received nothing in return. At a minimum, the amount received as rent should have increased in proportion to the capital expenditures made by ORG. These capital expenditures undoubtedly improved the ORG's overall profitability, which directly benefited CO-1. Accordingly, because ORG did not receive any benefit proportional to the amount of capital expenditures it made, we believe that CO-1 is reaping a benefit (increased revenue stream from the capital improvements made by ORG) which is more than incidental in both a qualitative and quantitative sense.

Community Benefit Standard.

In Rev. Rul. 69-545, the Service considered the following factors in determining whether a hospital operates to serve a public rather than a private interest. These factors are commonly known as the "community benefit standard":

Whether control of the hospital rests with a board of trustees composed of independent civic leaders.

Whether the hospital maintains an open medical staff, with privileges available to all qualified physicians.

Whether the hospital operates a full-time emergency room open to all regardless of ability to pay.

Whether the hospital admits all patients able to pay (either themselves, or through third party payers such as private health insurance or government programs such as Medicare).

Whether the hospital uses its surplus funds to improve the quality of patient care, expand facilities, and advance its medical training, education, and research programs

In the instant case, the terms of the lease agreement required that a full time emergency room be operated on a 24-hour basis, open to all regardless of their ability to pay. CO-1's own financial statement states that the value of the health services provided to patients who are financially unable to pay is not material to CO-1's overall results of operations. CO-1's priority is the return of investment to its stockholder. Their policy to patients as noted in the trustees minutes is that unless it is a life or death situation, the patient has to pay CO-1's fee or go somewhere else for the elected procedures.

The examination also indicated that the rental fees ORG received under the lease agreement were used to expand the medical facilities of the ORG. Control of the ORG, however, rested entirely with CO-1, a for profit entity, which had a substantial economic interest in the operations of the ORG. Based on the findings of our examination, CO-1 used its control of the ORG for its own private benefit, mainly to maximize its own profits. By relinquishing complete control of the ORG to CO-1, ORG fails to meet, the community benefit standard as set forth in Rev. Rul. 69-545 and no longer operates for an exempt purpose.

Building Purchases

Since entering into the lease, CO-1 has been the primary beneficiary of the buildings purchased by ORG. CO-1 did not paid rent for seven yet used the Medical Complex building to recruit medical doctors who in turn procured them patients for the ORG. CO-1 started paying rent in 19XX after ORG made additional leasehold improvements totaling \$. The doctors benefited from the low rent and received an advantage over other doctors with established practices. Again, the benefits provided to CO-1 and the doctors far surpassed the benefit to ORG considering that no remuneration was received for seven years.

The examination also revealed that ORG purchased an adjacent medical office building from four doctors, leased it to CO-1, who subleased back to the four doctors. ORG purchased the building for \$ million and leased it to CO-1 for an annual rent of \$. The examination indicated that the primary purpose of ORG purchasing the building was to allow CO-1 to gain control over the building, and be released of its legal liability from the on going suits between the doctors. ORG claims that the purchase was a prudent investment and an IRS Engineer has determined that the rental fee charged to CO-1 was at fair market value. ORG also received a legal opinion stating the acquisition would not jeopardize its exempt status. Regardless of the fact that the purchase of the building may have been a prudent investment or that ORG received a legal opinion supporting the acquisition, it appears that the primary purpose of ORG is purchasing the building was for the benefit of CO-1, and the doctors, which is an impermissible private benefit.

TAXPAYER'S POSITION

The taxpayer agrees with the government's claim that they are no longer a ORG. ORG's negotiations attempts with CO-1 have not been fruitful. Copies of CO-1's correspondence attest to their unwillingness to rescind the lease and give back effective control to ORG. At the last meeting held with the Taxpayer and its representative, the latter told of the organization's plans to buy a building / office space to accommodate The Network and to proof that ORG continues to have a charitable exempt purpose. As of today, no documentation has been received by the office that such purchase took place.

CONCLUSION

We conclude that ORG no longer qualifies as organization exempt from federal income tax and is no longer described under section 501(c) (3) of the Internal Revenue Code. Under Section 6104(c)(3) of the Code, the Service would be required to notify the State of XYZ if this action becomes final.

We conclude that the effective date of revocation of exempt status is January 19XX. Effective the date on which this notice of change of status is made public, contributions to ORG will not be deductible to donors as a charitable deduction under section 170 and other provisions of the Internal Revenue Code that relate to charitable gifts and bequests. However, effective the date of revocation, contributions in part responsible for the acts that gave rise to revocation of exempt status are not deductible as charitable contributions on

· ORG
TIN

Form 886
Attachment
Revised Report

their tax returns. Rev. Proc. 82-39, 1982-2 C.B. 759. ORG is required to file Federal income tax returns for all tax years beginning with the tax year ending January 1, 19XX.

ISSUES

LEGEND

ORG = Organization name
companies

XX = Date

CO-1, CO-2 = 1st & 2nd

1. Whether ORG. (ORG) continues to maintain its exempt status under section 501(c)(3) after entering into a lease agreement with CO-1 and CO-2 (CO-2).
2. Whether ORG should have its exempt status revoked, and whether the effective date of revocation should be July 1, 19XX.



DEPARTMENT OF THE TREASURY
Internal Revenue Service
7850 SW 6th Court, Plantation, FL 33324

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

ORG
ADDRESS

UIL: 501.33-00

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Certified Mail - Return Receipt Requested

Dear Sir:

We have enclosed a copy of our report of examination explaining why we believe revocation of your exempt status under section 501(c)(3) of the Internal Revenue Code (Code) is necessary.

If you accept our findings, take no further action. We will issue a final revocation letter.

If you do not agree with our proposed revocation, you must submit to us a written request for Appeals Office consideration within 30 days from the date of this letter to protest our decision. Your protest should include a statement of the facts, the applicable law, and arguments in support of your position.

An Appeals officer will review your case. The Appeals office is independent of the Director, EO Examinations. The Appeals Office resolves most disputes informally and promptly. The enclosed Publication 3498, *The Examination Process*, and Publication 892, *Exempt Organizations Appeal Procedures for Unagreed Issues*, explain how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

You may also request that we refer this matter for technical advice as explained in Publication 892. If we issue a determination letter to you based on technical advice, no further administrative appeal is available to you within the IRS regarding the issue that was the subject of the technical advice.

If we do not hear from you within 30 days from the date of this letter, we will process your case based on the recommendations shown in the report of examination. If you do not protest this proposed determination within 30 days from the date of this letter, the IRS will consider it to be a failure to exhaust your available administrative remedies. Section 7428(b)(2) of the Code provides, in part: "A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted its administrative remedies within the Internal Revenue Service." We will then issue a final revocation letter. We will also notify the appropriate state officials of the revocation in accordance with section 6104(c) of the Code.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Internal Revenue Agent
Gulf Coast EO:7954

Enclosures:
Publication 892
Publication 3498
Report of Examination